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The Great Crisis and Fiscal Institutions in Eastern and Central Europe and Central Asia

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Abstract

This paper examines fiscal outcomes in Eastern and Central European countries before and during the global crisis of 2008–2010. These outcomes are evaluated in the context of overall changes in fiscal institutions and global market conditions. Eastern and Central European countries' situations improved dramatically in the pre-crisis period as tax revenues boomed, and fiscal institutions were reformed. Expenditures increased quite significantly in real terms for some of the countries in the pre-crisis era so that when tax revenues collapsed in the wake of the crisis, the countries were left with large deficits. Institutional reform helped countries manage their fiscal situations better, but the crisis also exposed shortcomings of the status quo. In the post-crisis period, fiscal institutions aimed at promoting fiscal discipline are being strengthened. Governments will also need to take a closer look at the sustainability of current expenditure patterns, particularly the strong emphasis on social expenditures.

This paper—a product of the Poverty Reduction and Economic Management Unit, Europe and Central Asia Region—is part of a larger effort in the department to analyze the effects of the Great Economic crisis and to disseminate work done in region. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The authors may be contacted at lbarbone@worldbank.org or rislam@worldbank.org.

The Great Crisis and Fiscal Institutions in

Eastern and Central Europe and Central Asia

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Introduction

In the years prior to the onset of the great crisis of 2008, high growth rates and a favorable external environment led to a decade of promising fiscal developments for countries in Eastern and Central Europe and Central Asia (ECA). They saw an unprecedented increase in fiscal resources as tax revenues burgeoned with accelerating growth rates. Public debt fell dramatically as a share of GDP. But rising revenues also meant that fiscal expenditures could grow; while expenditure growth rates were below those of revenue, they were still high, especially since the mid 2000s. The size of government did not fall, but rose in many cases. At the same time, for a large majority of the countries under consideration, the last decade saw the consolidation of deep institutional reforms, starting in many cases in the early 1990s, which aimed to dramatically change the way in which public expenditures and revenues were handled. Against this backdrop, came the global crisis and the impact on growth in ECA countries was severe. Consequently, fiscal outcomes suffered significantly.

This paper reviews fiscal outcomes during the 2000s against the backdrop of high growth rates and institutional advances across the region. In three cases, Turkey, Poland and Russia, we examine in detail how fiscal outcomes may have been affected by the types of fiscal institutions that countries adopted during the period leading up to the crisis. We find that not all institutional reforms were effective, partly because some (such as fiscal rules) may have been too inflexible to be operationally relevant in a crisis situation. Yet, on average, institutional reforms did help countries to better manage their fiscal situation. The first section reviews the macroeconomic and fiscal outcomes in ECA countries during the years leading up to the crisis of 2008-09 and the policies adopted in response to the crisis. The second section discusses the institutional reforms that were being adopted during this time and the third section focuses on how institutional reform in three countries, Poland, Russia and Turkey, in the period leading up to the crisis and in the crisis affected fiscal outcomes.

I. Fiscal Institutions and Outcomes

This paper draws from an extensive literature in exploring the relationship between fiscal institutional designs and fiscal outcomes. It builds on the insight that the public budget is subject to a common-pool problem where individual agencies (interest groups) tend towards over-consuming the (common) resource- public funds (Weingast, 1981 and Weingast 198, Shepsle and Johnson, 1981). Thus more fractured public sectors would have a greater tendency to over-spend, generate deficits, and grow debt, a view that has been confirmed by empirical investigations beginning in the early 1990s with the work by Jurgen von Hagen and others (1992, 1994, 1996, 2006, 2008) concerning EU fiscal systems. Velasco (1999), Tornell and Lane (1999) have formalized this insight.

The approach to measuring the degree of fiscal fragmentation has centered on the powers of the ministry of finance in the three main stages of budgeting: preparation, approval and implementation. Fiscal centralization corresponds to situations where the finance minister has a strong role in setting and enforcing fiscal targets, resolving conflicts over spending, and has the authority to block expenditures in order to ensure that actual expenditures do not exceed authorized levels. In addition, the legislature has limited powers to amend the budget or increase aggregate expenditure. The finding has been that rules giving the ministry of finance strategic dominance on budgetary arrangements and in enforcing budget discipline, and limiting the amending power of parliaments and the opportunities for modification during implementation are "strongly conducive to fiscal discipline, i.e. relatively small deficits and public debt."

(Hagen, 1992, p.53). That centralization of authority over allocation and during execution of budgets matters for fiscal outcomes has been confirmed for later periods for the EU and EU accessions countries by the same and other authors (see Mulas-Granados, etc. (2006). It has also been found relevant for Latin America by Alesina et al. (1999b) and Stein et al. (1999), and Filc et al. (2004). Dabla-Norris et al. (2010) find evidence that the relationship between the design of fiscal institutions and fiscal outcomes holds in low-income countries as well.

Political fragmentation has also been found to drive fiscal outcomes indirectly by precluding or facilitating agreements on core institutional designs and, directly, through the competition for budgetary resources. Fabrizio and Mody (2008) review the channels linking politics to fiscal outcomes. In politically fragmented environments, a "desirable" allocation of mandates may be infeasible because political actors may fail to come to an agreement on institutional consolidation. Hagen and Hallerberg (1999) contend that in such environments a "contract" as opposed to a "delegation" approach works better. The contract approach would seek agreements among relevant parties at the start of the budgeting process, with the bargaining among the parties providing the framework for developing a comprehensive view of the budget thus overcoming the common pool externality. In extreme case, however, the symbiosis between institutional and political fragmentation can lead to tightly-knotted arrangements that delay reforms and follow the dynamics described by Alesina and Drazen (1993.)

Transparency in budgetary practices as an aide to delivering better fiscal outcomes has also received attention in the literature: transparency can help prevent players from hiding incomes, expenditures and especially negative fiscal outcomes. But implementing transparency can be difficult in practice. Alesina and Perotti (1999) in discussing the relevance of transparency pointed to possible measurement difficulties. International institutions have invested in developing transparency measurement criteria such as the IMF *Code of Good Practices on Fiscal Transparency*, which has been used to produce Reports on Observation of Standard and Codes (ROSC) for a large number of countries. Using information from these reports Hameed (2005) finds that transparency matters to delivering fiscal discipline, controlling corruption and achieving better credit ratings. (See also Debrun, and Kumar, (2007) on the disciplining role of transparency. Alesina (2010) is of the view that transparency in the budget and outcomes is the most important element in delivering good fiscal outcomes because it is more difficult for pressure groups to hide wasteful programs in an environment of greater transparency.

The traditional focus on (primary) deficits and debt to GDP ratios has been shifting to the pro-cyclical fiscal behavior of governments, something which seems ubiquitous in developed, transition and developing economies. Fragmentation and lack of transparency are found also to explain pro-cyclical fiscal behavior. Alesina et al. (2008) indicate that in developing countries pro-cyclical behavior is likely to be linked with a lack of transparency. Given that pro-cyclical behavior occurs even in European economies ranked high on transparency standards, other factors are likely to be at play. Complementary explanations therefore point to the inability to make credible inter-temporal commitments to the future allocation of resources. Balasone, and Kumar (2007) review the challenges of cyclical behavior for fiscal institutional design.

In countries around the world, considerable attention has been given to improving fiscal institutional designs anchored on the emerging consensus that institutions matter for fiscal outcomes. Fiscal institutions of various types have been adopted to counter budgetary fragmentation and non-transparency in fiscal policy. The underlying presumption is that certain budgetary procedures could reduce institutional fragmentation, increase transparency and improve fiscal outcomes; these procedures are often strengthened when they are supported by quantitative targets which facilitate adherence and monitoring. Within this strategic framework, the on-going efforts to tame pro-cyclical behavior and ad-hoc changes in budgets emphasize the introduction of Medium Term Expenditure Frameworks (MTEFs), or multi-year fiscal policy and planning embedded in consistent macro-economic projections. MTEFs, along with other measures to bolster data release, enhance transparency, and by facilitating discussions on quantitative and monitorable outcomes, facilitate good policymaking. In practice, the worldwide experience, including that in transition economies, over the last two decades indicates that such investments in supporting fiscal systems take time to design and implement.

One type of fiscal institution, fiscal rules, have a long and successful history at sub-national levels in the US and in Switzerland. At the national level, they have become popular worldwide only recently. In 1990, five countries had fiscal rules at the national level; over 80 countries today have them. Fiscal rules can be adopted nationally or be part of external agreements like they are for the EU countries. Some countries (e.g. Poland) have both national and supranational rules. The design of fiscal rules varies but overall the focus of these rules is to constrain fiscal aggregates by introducing ceilings on fiscal balances, public debt to GDP, or overall expenditures, or by setting overall revenue targets. The literature finds that rules may enhance fiscal discipline. However, focusing on rules that are not binding in good times (when revenues are rising fast) may not impede pro-cyclical behavior and a deterioration in fiscal policy. Therefore, better designed fiscal rules would place greater emphasis on debt sustainability and smoothing expenditures over the economic cycle with an emphasis on structural deficits in an effort to address inter-temporal inconsistencies. Recently Chile adopted a fiscal rule, whose design takes these issues into account. The inherent risk in defining and using these rules, however, lies in increasing the complexity by requiring a good understanding of where the economy is in the cycle and identifying the "special circumstances" that may require deviating from them. Differentiating between cyclical downturns, short term shocks and longer term trends is not an easy matter, even in developed countries.

There is also some skepticism about the role of rules. This skepticism centers on the observation that rules work best when they are not binding. Schick (2009) notes that "Fiscal rules should have much of their bite when the economy is strong; if they do not, they may do much harm and little good when the economy is weak." Thus, the test of rules and strong institutions more generally is the ability to manage the good times. Institutions that complement fiscal rules and bolster inter-temporal consistency of fiscal policy are Independent Fiscal Agencies (Eichengreen, Haussman and Hagen (1999)). The concept of establishing fiscal agencies to independently assess, monitor and evaluate fiscal policy builds on the positive experience with Central Bank independence and the conduct of monetary policy. Potential mandates for such agencies include setting the yearly level of the deficit or surplus and ensuring debt sustainability; in the case of an abrupt economic change the agency would have the mandate to adjust the fiscal stance as needed. Fiscal agencies, with a variety of mandates, have been emerging with a focus on independent forecasts, analysis or normative judgments; these types of agencies can help meet institutional deficiencies specific to individual countries.

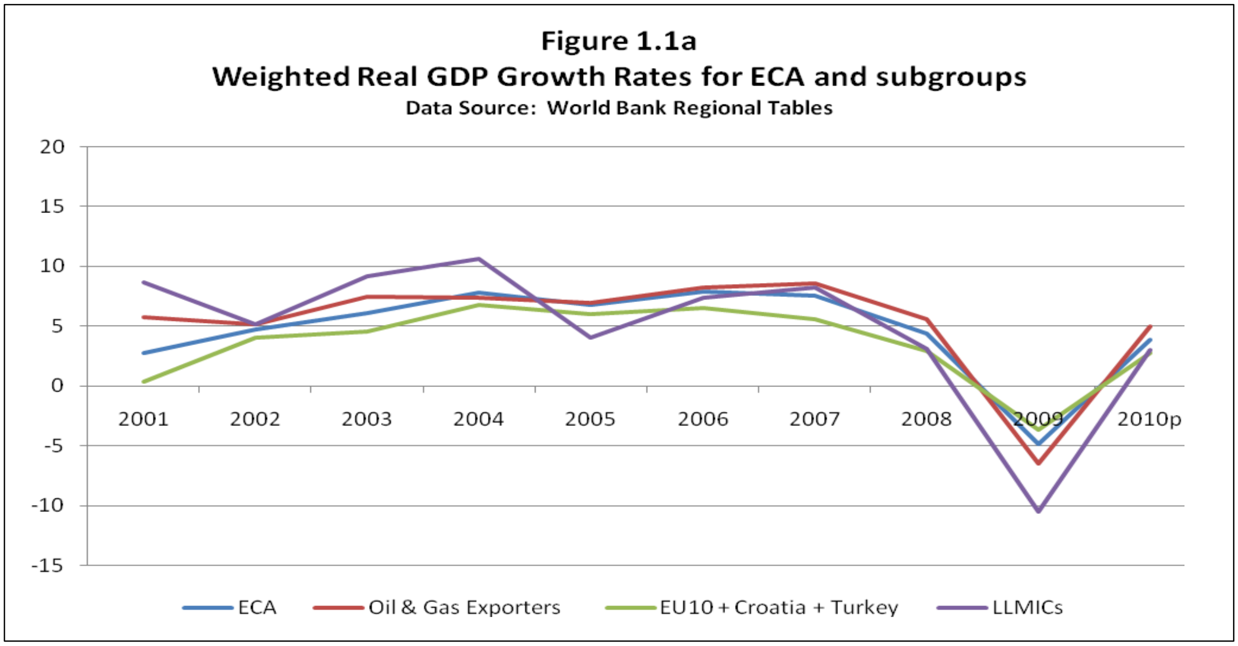
A working hypothesis today is that fiscal institutions can support good policy making and in particular, fiscal rules can serve to deliver improved fiscal outcomes in politically fragmented environments. The view has been that fiscal rules can help lock in gains by introducing (quantitative) hard budget constraints, complementing sound institutional designs for budget management and a policy of transparency that responds to the demands of various constituencies.

A broader question is whether legislation establishing fiscal rules alone can substitute for inadequate institutions in highly fragmented political and institutional environments, by-passing the painful efforts of broader institution building in which fiscal rules would be one ingredient.

II. Fiscal Outcomes in the 2000s in Europe and Central Asia

During 2005-07 ECA countries averaged a growth rate of 6.7% as compared with 5.2% during 2000-04 and 3.8% during 1995-2000.[2] While there was a great deal of variation among countries, (for example, Azerbaijan grew at 25% in 2007 versus Turkey at 4.7%), growth was higher than the average in half the countries during 05-07. Figures 1.1a and 1.1b below, show average growth rates during this period for all of ECA but also different groups in ECA. Growth in incomes reflected both large increases in investment, consumption and increasing integration in world markets.

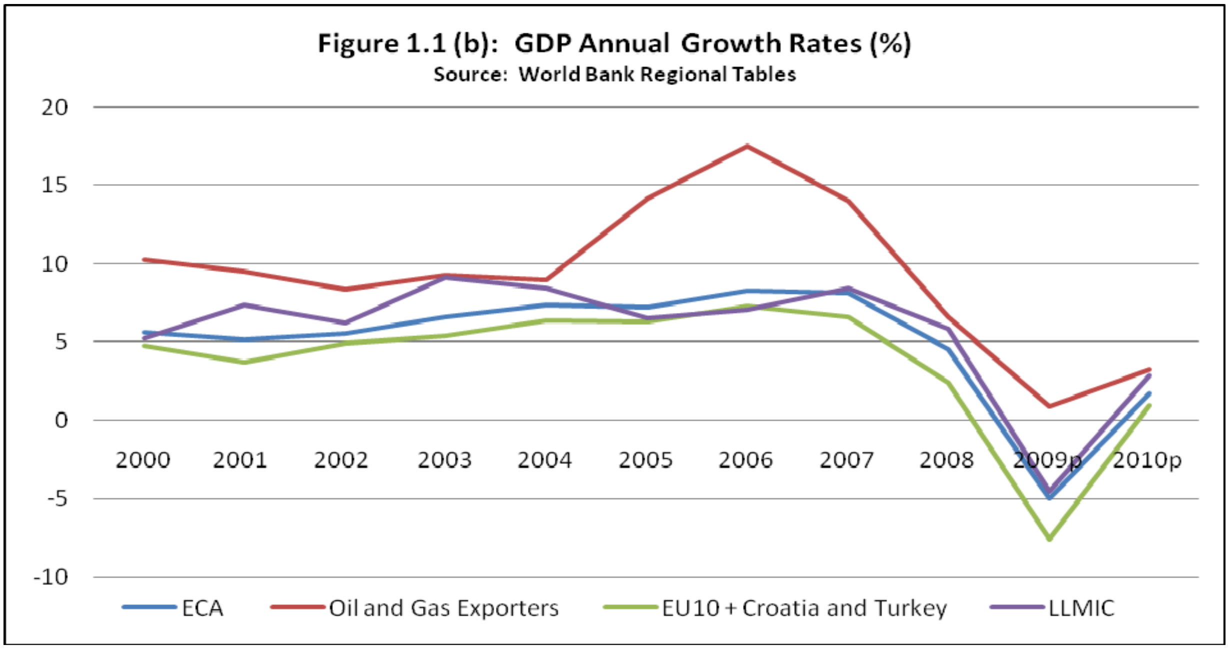
[2] All averages relative to GDP will be GDP weighted unless otherwise stated. Unweighted growth rates were 7.8% overall, 15.2% for the OGE, 6.7 for the EU10+ and 7% for the LLMIC.



High GDP growth and increasing integration had substantial impacts on the fiscal position of ECA countries, the effect differing among countries depending on their initial conditions. For example, for the oil and gas exporters (OGE) fiscal developments are closely tied to world markets for oil and gas[3]. Fast growing world markets meant high export values and high corporate profits. Fiscal revenues rose substantially. At the same time, in these economies the management of fiscal revenues from the oil and gas sectors has been of significant concern. The EU accession countries are distinguished by the nature of the fiscal and other structural reforms they have undertaken. This group which also has the higher income countries of the ECA region experienced a higher increase in trade integration than the other groups in the region. The graph EU10+ includes Croatia and Turkey in the group[4]. The decline in trade during the crisis affected tax receipts in many of the smaller countries substantially in the crisis. The low and lower middle

[3] The oil and gas exporters are Kazakhstan, Russia and Azerbaijan.
[4] The UE10+ group is composed of: Poland, Latvia, Lithuania, Hungary, the Czech Republic, Slovenia, Slovakia, Bulgaria, Estonia, Croatia and Turkey.

income countries (LLMIC)[5] also had substantial growth in output and trade during the pre-2008 period which had a positive impact on their fiscal outcomes, even though their fiscal institutions are less developed.



III. Rising Size of the Public Sector

ECA countries' fiscal situations improved dramatically alongside growth during 2000-07 and the first half of 2008, in large part because of substantial fiscal revenue growth in their booming economies. During this period most countries also reformed tax policies and institutions. The reforms of tax policies aimed to reduce the tax burden on the private sector with the aim of supporting investment and growth but at the same time, reforms sought to broaden the tax base to maintain tax revenues. During this period, many countries also began reforms to

[5] The LLMIC are: Albania, Armenia, Georgia, Kosovo, Kyrgyz Republic, Moldova, Tajikistan, Ukraine.

enhance the efficiency of expenditures and to rationalize government spending. However, in the mid-2000s, some of the efforts appear to have weakened.

From the early 2000s to 2007, real fiscal revenue growth in ECA was high and rising. As a share of GDP revenues were 33.6% during 1995-2000, and 32.5% during 2000-2004. As GDP accelerated, real fiscal revenue growth in ECA was high and rising and surpassed GDP growth in 2005-07 to be 35.2% of GDP. As a ratio to GDP, revenues rose the most in the LLMIC group (outside of the oil related revenues accruing to the OGE), and the least in the EU+ countries, even though real growth was 7.5% in 2007 for this group. When averages are weighted by GDP however, the OGE revenue to GDP ratio is fairly constant (implying that in the larger countries, growth was slower), though the LLMIC come out stronger. Among the EU10 countries, the revenue share to GDP was fairly constant when weighted, but rose for the unweighted average as small countries experienced a rising share. In countries where revenues followed patterns in imports, they would have exhibited more volatility relative to GDP. In 2007, 30% of ECA countries had real fiscal revenue growth above 10%[6]: Armenia, Azerbaijan, Belarus, Bulgaria, Georgia, Kazakhstan, Kyrgyz Republic, and Montenegro. Just under half the countries had real revenue growth over 10% in 2006, and 40% in 2005. By 2007, fiscal revenues to GDP were 36.4%, though the OGE were at 39%- in weighted terms (Figures 3.1a and 3.1b).

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[6] The GDP deflator is used in calculating real values.

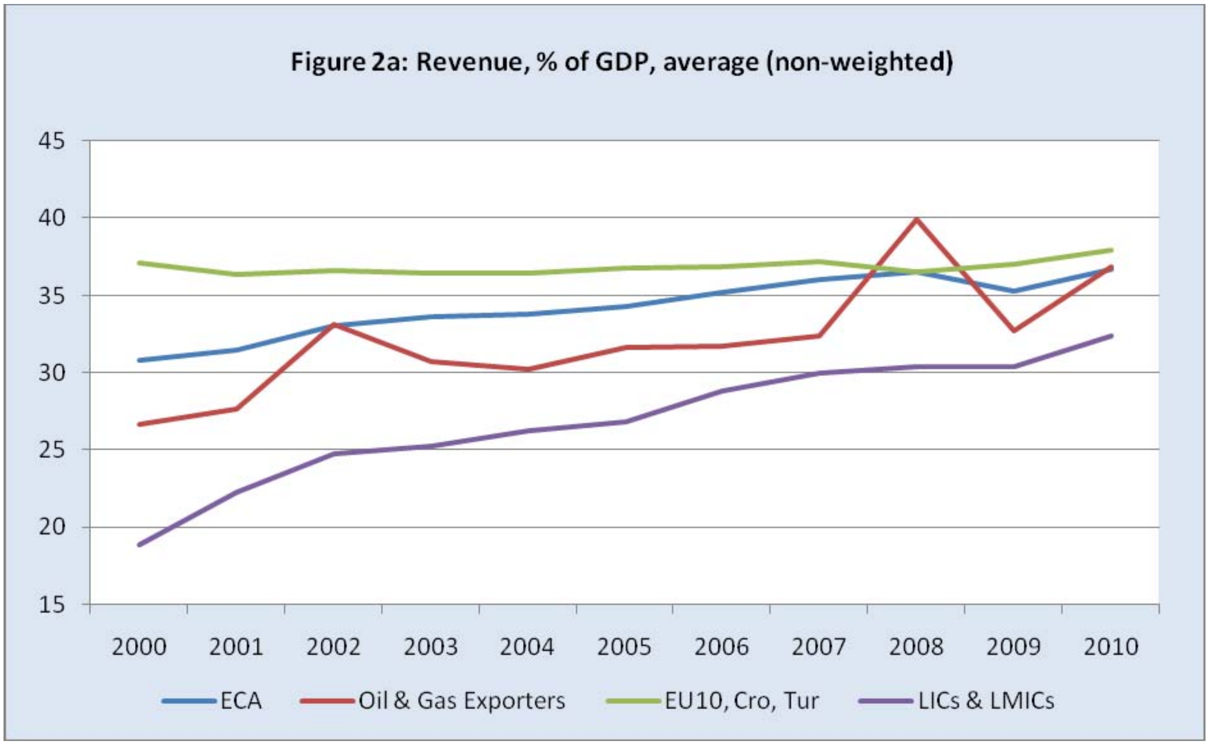


Figure 2a: Revenue, % of GDP, average (non-weighted)
45
40
35
30
25
20
15
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
ECA
Oil & Gas Exporters
EU10, Cro, Tur
LICs & LMICs

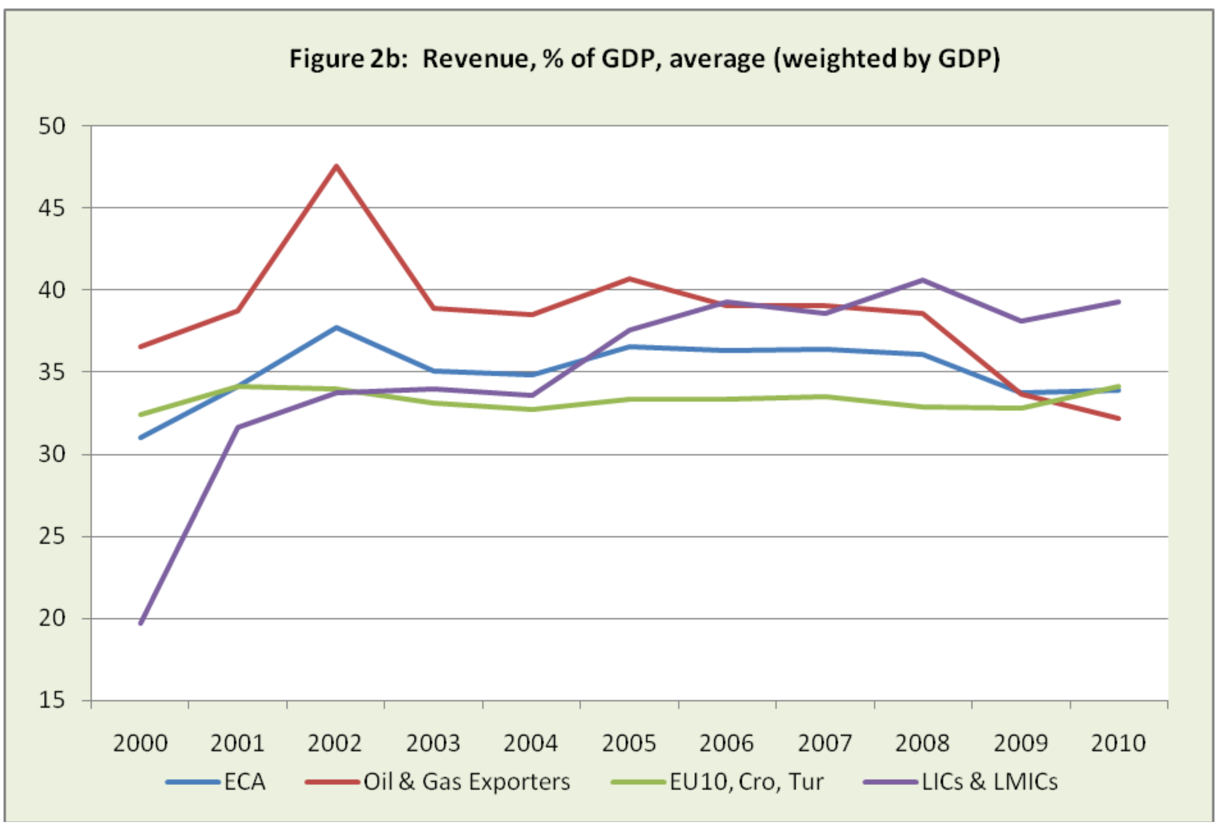
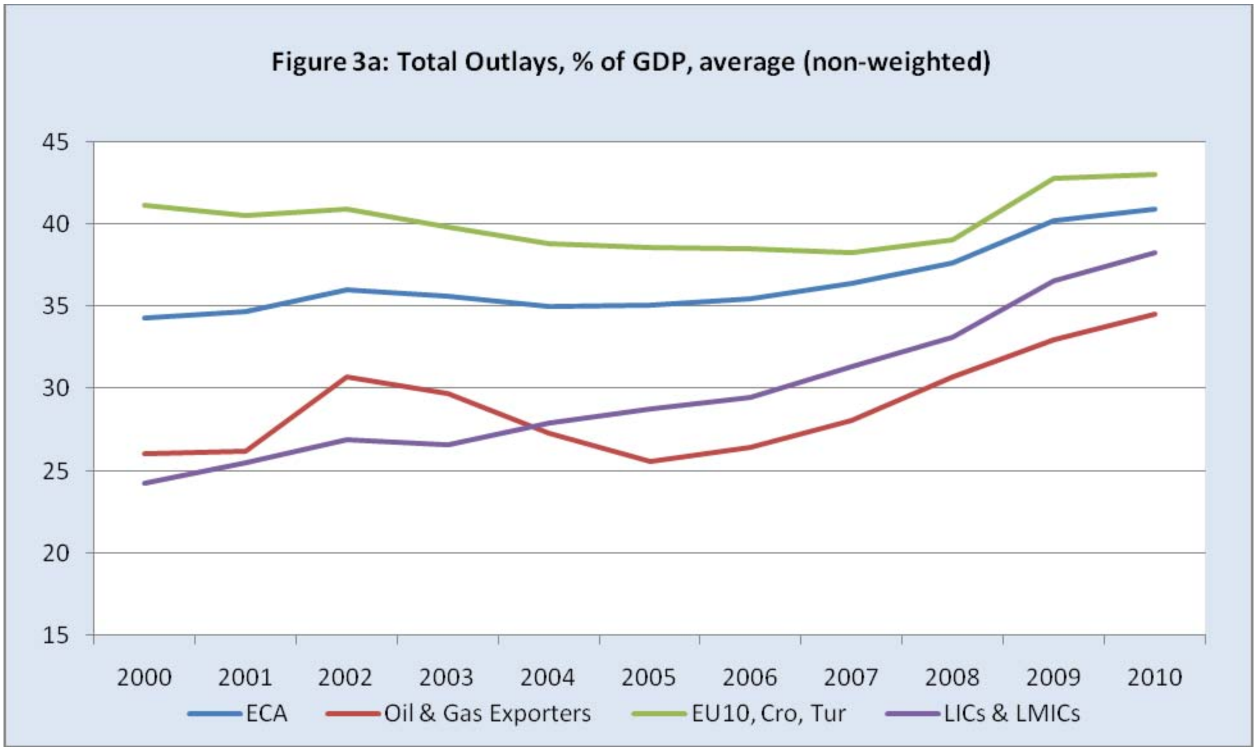
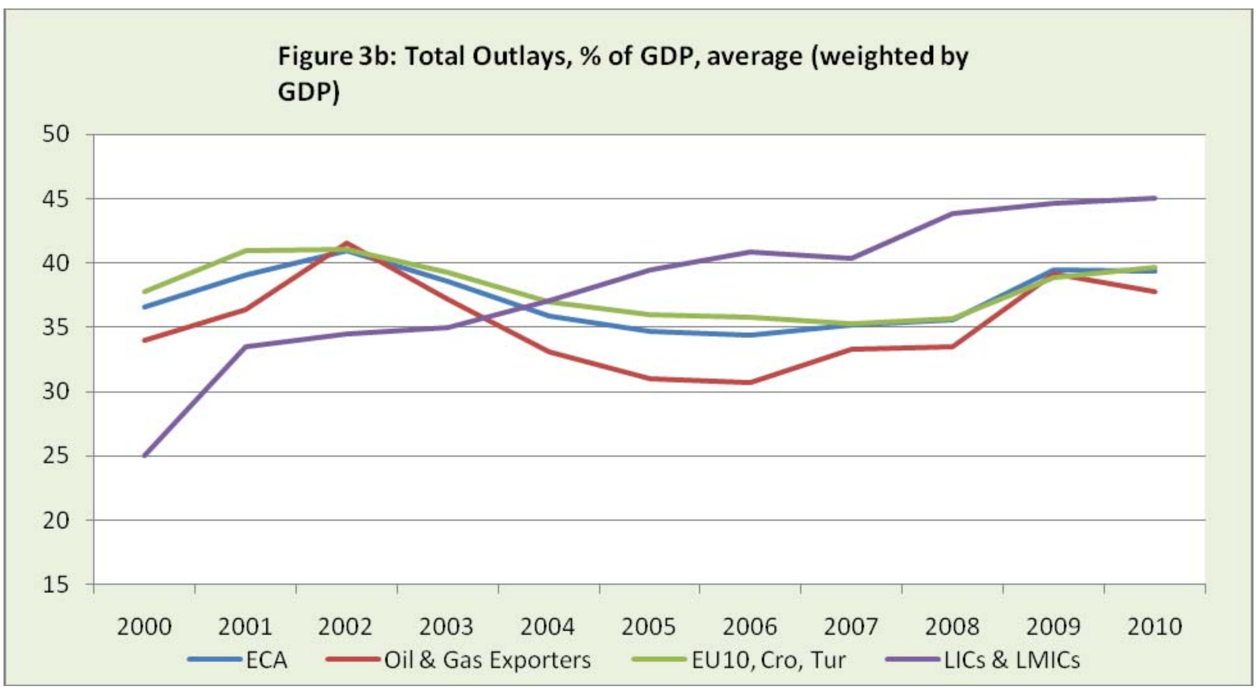


Figure 2b: Revenue, % of GDP, average (weighted by GDP)
50
45
40
35
30
25
20
15
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
ECA
Oil & Gas Exporters
EU10, Cro, Tur
LICs & LMICs





At the same time, average fiscal expenditures grew from just over 34.3% percent of GDP in 2000 to an average of 36.4% percent of GDP by 2007 though they fell in weighted terms until

2007.[7] There was a lot of variation among countries. In fact, despite much higher GDP growth in the 2000s relative to the period 1995-2000, expenditures grew faster for many countries, though in GDP weighted terms, fiscal expenditures relative to GDP declined until 2007 for the EU10+ and OGE groups, but not for the LLMIC group. During 2006-07, average expenditure growth was more than 10% in real terms. Real expenditure growth was over 10% in 12 ECA countries in 2007 and in 9 countries in 2006. The period 2004-07 is distinguished by an acceleration in expenditure growth (see Figures 3a and 3b).

IV. The Impact of the Crisis

Until the crisis struck, deficits and debt showed tremendous improvements in the 2000s. During 2000-03, the GDP weighted fiscal balance was a deficit of 3 percent of GDP on average. This reflected higher deficits in the EU10+group of over 6 % of GDP percent on average and in the LLMIC of 2 percent. The OGE had surpluses during this time. Due to impressive revenue performance, and strong growth, the debt to GDP ratios of ECA countries improved dramatically during 2000-07, the ECA (weighted) average falling from 46 percent of GDP to 23 percent of GDP. The decline was the largest in the LLMIC countries where debt/GDP fell by around 16 pp of GDP from 47 percent to 31 percent. The EU10+ group had smaller declines and was the most indebted in 2007.

When the global economic crisis struck ECA countries in 2008, governments had already programmed large increases in expenditures and had to adopt revised budgets in 2008 that cut expenditures during the year in expectation of shortfalls in revenue. However, none of the ECA countries had declines in nominal expenditure levels (and only 6 had declines in real terms).

[7] Note that all growth rates are given in unweighted terms.

Though the crisis in 2008 had an immediate impact in many countries, 24 countries still had nominal expenditure growth of over 10 percent in 2008 (though only 10 saw growth in real terms at this rate) and 15 had growth over 20 percent (though only 1 had real growth at this rate). The adjustment is more visible when looking at expenditure to GDP ratios which fell (in terms of percentage points of GDP) in 11 countries in 2008 and 6 in 2009.

A. The crisis

As a result of the changes in expenditures and revenues, in 2009, the average deficit for ECA rose by over 4 pp of GDP relative to 2008 and 6 pp of GDP relative to 2007. Seven countries had a deterioration of 5 pp or more. Russia and Kazakhstan stand out with very large deteriorations reflecting their large stimulus packages. But the largest deficits were in Latvia and Lithuania (9%) with Georgia and Romania following (8%) in 2009. Sixty percent of the countries with the largest deficits in 2009 (near 7% or above) had the highest share of taxes coming from VAT/taxes on goods and services.

In order to manage their fiscal positions, ECA countries undertook a number of policies. There was a wide variation in responses, with some countries raising taxes, others lowering them, some running arrears and others reducing expenditures of various kinds. Some of the policies adopted are short term in nature and expected to be reversed (for example, lengthening the duration of unemployment compensation, or announcing temporary VAT cuts); others will need to be considered more carefully in the longer run (for example, the desired level and type of capital expenditures). The fiscal policies used are summarized in Table 1 below:

Table 1: Fiscal Policy in the Crisis

	Fiscal Policies In the Crisis Years 2008-09
Wage Bill (Wage Growth/Employment) [8]	Armenia, Belarus, Bosnia, Bulgaria, Croatia, Czech Republic, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Ukraine
Pensions: Indexation change or oth adjustment[9]	Albania, Belarus, Bosnia, Croatia, Estonia, Georgia, Hungary, Latvia, Macedonia, Romania, Russia, Serbia, Tajikistan,
Tax Cuts	Armenia, Belarus, Czech Republic, Estonia, Kazakhstan, Latvia, Lithuania, Macedonia, Poland, Russia, Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine
Tax Increases	Belarus, Croatia, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Serbia, Slovenia, Ukraine
Financial Sector Measures[10]	Albania, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Republic, Hungary, Kazakhstan, Latvia, Montenegro, Poland, Russia, Slovakia, Slovenia, Ukraine
Cuts in Capital Expenditures[11]	Armenia, Azerbaijan, Belarus, Bosnia, Bulgaria, Croatia, Hungary, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Romania, Serbia, Slovenia, Turkey, Ukraine
Increases in Capital[12] Expenditures	Czech Republic, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Macedonia, Moldova, Poland, Russia, Slovak Republic, Tajikistan
Arrears Owed to or by Government[13]	Albania, Bosnia, Bulgaria, Croatia, Kosovo, Latvia, Moldova, Montenegro, Romania, Russia, Tajikistan
Employment/Unemployment Related Policies	Armenia, Bosnia, Bulgaria, Croatia, Czech Republic, Kazakhstan, Latvia, Montenegro, Romania, Russia, Slovak Republic, Slovenia, Tajikistan, Turkey
Change in Subsidies to Enterprises/ Other	Armenia, Azerbaijan, Croatia, Estonia, Kazakhstan, Macedonia, Moldova, Montenegro, Romania, Russia, Serbia, Slovak Republic, Slovenia, Turkey, Ukraine
Increase in Social Transfers[14]	Albania, Armenia, Azerbaijan, Belarus, Croatia, Georgia, Hungary (lowered), Kazakhstan, Kyrgyz Republic, Latvia, Lithuania (lowered), Macedonia, Moldova, Montenegro, Romania, Serbia, Slovak Republic, Slovenia, Tajikistan, Ukraine

[8] Kosovo, Kyrgyz Republic and Kazakhstan had wage increases in 09. The Czech Republic had a wage increase but employment reduction. The others had declines in wages and/or employment. Several countries had declines in general current expenditures as well.

[9] Russia, Tajikistan and Turkey had increases in 09.

[10] Does not cover central bank support of various kinds to the financial sector.

[11] These refer to cuts in 09. Though countries may have begun adjusting at end 08, the overall numbers may or may not have shown adjustments.

[12] These refer to increases in 09. Though countries may have begun adjusting at end 08, the overall numbers may or may not have shown adjustments.

[13] For Montenegro and Russia they were arrears owed to government.

[14] Some countries adopted policies to rationalize expenditures in the social sectors, e.g. eliminating free-of-charge textbooks. These are not addressed here but are explained in the full country matrices.

Public Works	Armenia, Bulgaria, Hungary, Kazakhstan, Macedonia, Moldova, Russia, Slovenia, Tajikistan, Turkey

Table 1 indicates that most governments had policies to contain the wage bill, and most had some sort of tax policy change during the crisis. Their efforts indicate that public sector compensation is (and will probably remain) an issue for budget management. Many countries used tax cuts to stimulate spending, but some had to increase taxes to offset the dramatic revenue declines or tax rate declines of previous years which took effect during the crisis years. Several supported their financial sectors and many governments took measures to help the unemployed and vulnerable.

In sum, an analysis of the fiscal outcomes of the 2000s reveals that governments had substantially improved their fiscal positions in terms of reducing deficits and debt until the crisis struck in 2008. It also highlights how fiscal adjustment if measured in terms of deficits and debt, may be relatively painless under high growth rates. The decline of 2008, however, illustrates the risk that volatile environments pose for fiscal outcomes. While governments were able to go on a spending spree in the mid 2000s, greater restraint would have meant lower deficits in the crisis. ECA countries adopted both expenditure and tax policies to (a) contain deficits or (b) boost aggregate demand or alternatively, (c) protect certain segments of the population. Many of the policies they adopted were short-term in nature (for example a freeze on wages) and would have been less necessary with more restraint.

Any review of developments in the ECA region in the pre-crisis years and extensive efforts to contain budgets in the crisis years would be incomplete without some assessment of the institutional changes that were taking place in these countries as fiscal outcomes improved in the 2000s. The next section describes some of these important changes in ECA’s fiscal institutions and the following section examines the impact of institutional changes in three countries.

V. Fiscal Institutional Reforms: A Bird's Eye View[15]

The design, reform or creation of fiscal institutions has been a major challenge for transition economies where defining the boundaries of the state has been and remains a continuing challenge. The point of departure in the reform process across countries differed substantially depending on the length of time each country spent under socialism and the type of socialism it practiced. All countries faced severe political and institutional fragmentation, which led to the emergence of soft-budget constraints with noted fiscal consequences that delayed the transition process (Kornai et al. (2003), World Bank 2002) The efforts to address these challenges included the corporatization of productive and financial enterprises and their privatization as well as setting the institutional frameworks for social security, and introducing fiscal systems for local and regional governments. The fiscal institutional building agenda focused on fundamentals, such as taxation, accounting, treasury and the establishment of budgetary procedures. These changes have happened in a fluid and fragmented political situation. Not surprisingly, design and implementation of these agendas has taken time and proceeded in spurts often linked to external events. The efforts by transition economies to close institutional gaps that existed with respect to market economies provide valuable experimental information on the process of change and the role of fiscal institutions in reducing fragmentation and increasing transparency, the importance of political fragmentation, and the contribution of economic events.

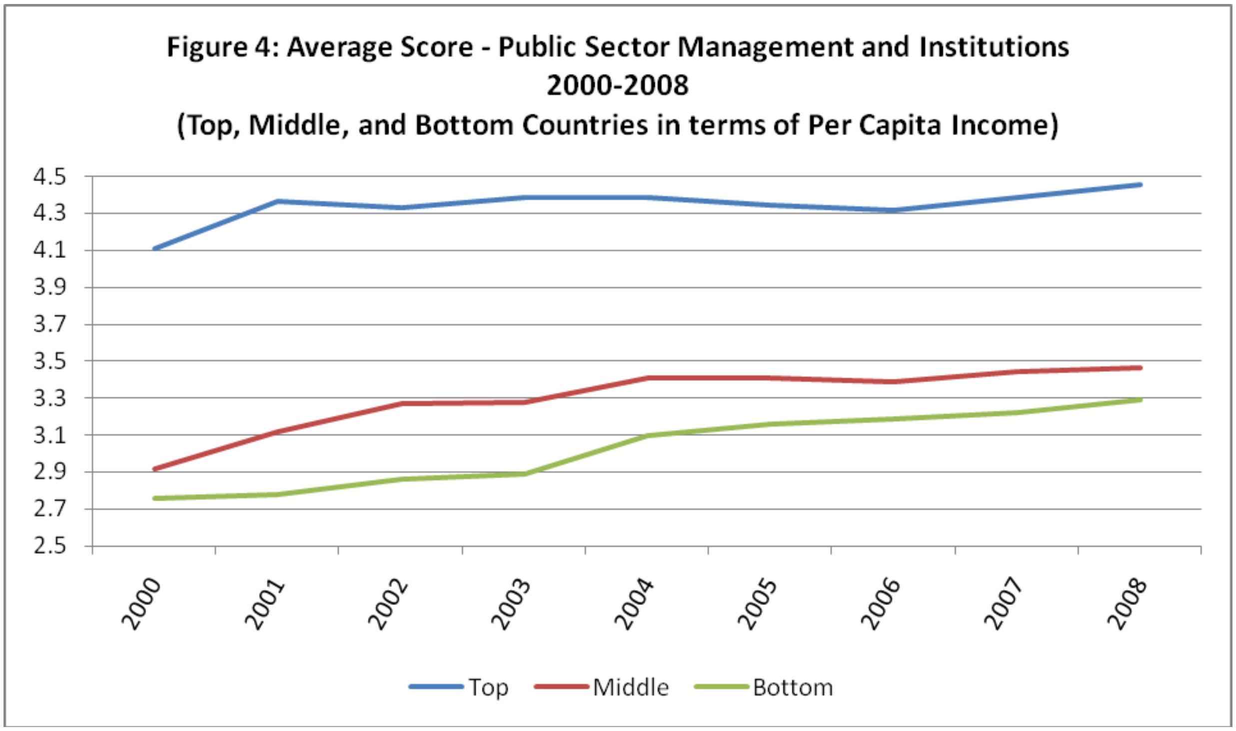
[15] This section is drawn from "Fiscal Institutions in ECA countries" Eckhardt and Islam (2010) draft.

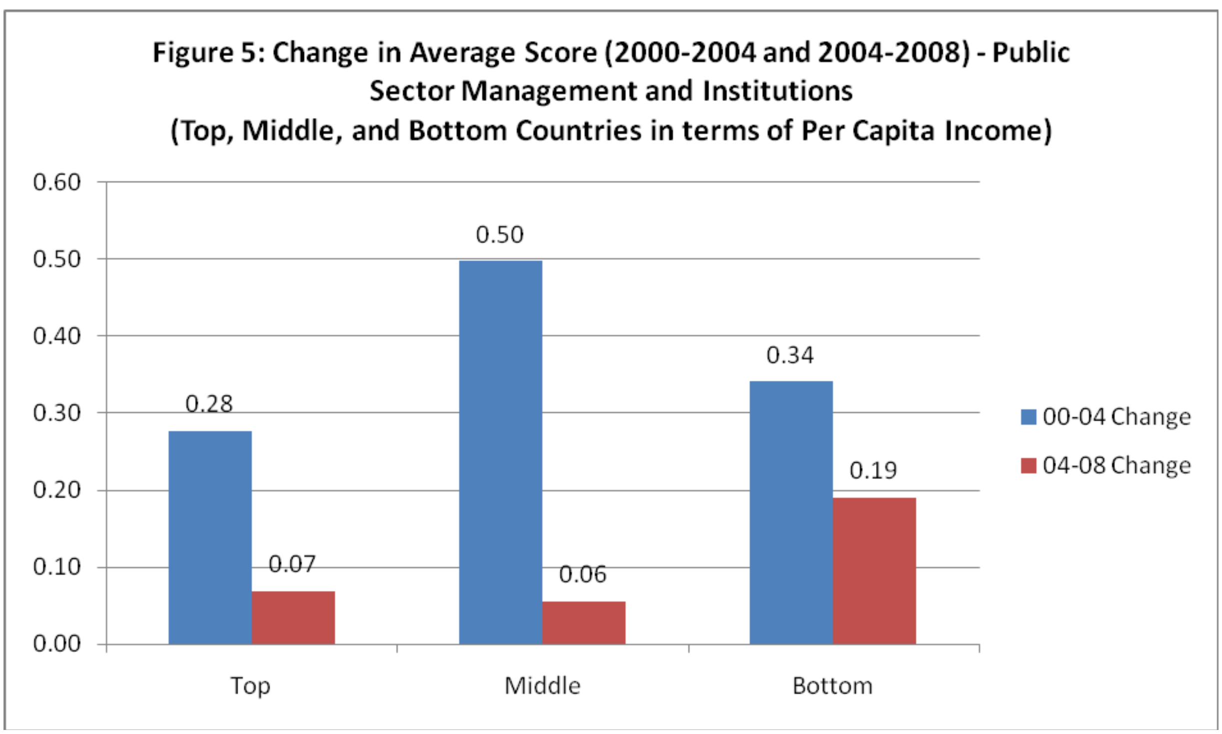
As discussed, the 2000s, particularly the latter half, saw high growth rates and improving fiscal positions. During this time ECA countries were very outward focused integrating with global markets. Higher integration meant also that changes in the external environment became very important for fiscal policies and outcomes. Many countries acceded to the EU adopting EU reforms, while other countries saw change to various degrees. The crisis of the late 2000s brought certain weaknesses in fiscal management to the forefront of policy discussion during this period of fiscal adjustment. The 2008/09 crisis tested the readiness of some of the institutions ECA countries had put in place and highlighted areas in which countries need to move forward.

Most countries in the ECA region have made progress in reforming their fiscal institutions, but the pace of institutional change has been uneven. The World Bank's Country Policy and Institutional Assessments (CPIA) attempt to measure the quality of policy and institutions in member countries in a number of areas. These assessments are based on both quantitative, monitorable indicators of policy and institutional reform, as well as judgments by country teams.[16] One of the indicators considered relates to the quality of public administration. Its evolution suggests that the majority of countries have made some progress over the past decade, and while some countries seem to have stagnated, none of the countries seems to have experienced a major deterioration in institutional quality. However, the quality of fiscal systems continues to differ across the region with differences in income levels. Figure 4 below shows the evolution of the CPIA indicator for ECA countries separated into three groups according to GDP per capita. The top third in terms of income per capita have much higher scores as might be expected, but countries at the lower and middle income categories have also been improving.

[16] Countries are rated on a score of 1 to 6.

Variance in institutional quality for a given level of income is greater among lower and middle income countries, while it converges among the high income countries.





The first part of the decade saw the largest change in institutional quality for all groups as Figure 5 shows. The middle group had the greatest improvements, followed by the countries in the bottom third income group. In the second half of the decade, the rate of change in institutional improvement was stronger in the lowest income group among the ECA countries. Despite these changes in the second and third tier income groups, the top countries in terms of per capita income have much better quality of institutions.

Overall in ECA, the fiscal reform agenda has evolved over the last decade. The first decade of transition (1990-2000) was dominated by institutional changes designed to overcome the legacy of central planning systems. During this time, reforms included the establishment of treasuries to improve the execution of the budget and cash management, the gradual integration of off-budgetary funds, the clarification of roles and responsibilities of different institutions in the budget process, establishment of democratic checks and balances, such as legislative budget approval and establishment of external audit institutions. There were major fiscal consolidation efforts in many countries of the region. Many countries put in place fundamental financial management regulations through the adoption of organic budget and treasury laws.

With the most basic fiscal management foundations in place, the reform agenda during the second decade (2000-2010) has moved to tackle more advanced challenges, such as linking expenditure prioritization more closely to policy objectives, introduction of a medium term perspective in fiscal policy, mostly through the adoption of Medium Term Expenditure Frameworks (MTEF) and a move away from detailed input controls to more performance and results orientation in expenditure management. Most countries in the region have some form of MTEF with differing degrees of integration with the budget process. Armenia‘s MTEF for example, is an integral part of the budgetary process. In Croatia, the MTEFs are formally adopted by Parliament. In addition, countries have begun adopting various kinds of fiscal rules to contain budgets and public debt (the EU accession countries have supranational rules under the convergence programs which limit debt and deficit ratios to GDP). Tax administration reforms have also advanced and many countries have begun to adopt practices compliant with the principles of self-assessment, better risk management, simplicity, greater transparency, client segmentation and specialization aimed at reducing compliance burden and administrative costs.

In addition, along with the democratization of political systems across the region, parliaments have taken on strong oversight roles in the budget process in most countries. Legislative scrutiny and enactment of annual budget laws is an essential element supporting government accountability. This type of scrutiny is intended to provide both an institutional check on executive power and voice to public demands. As the role of legislatures has grown budget decisions have become more transparent across ECA countries. This was particularly important during the recent crisis when many governments had to undertake budget amendments and difficult budgetary decisions.

The specific role of Parliaments and the authority they enjoy vary across countries, and depend to a great extent on the constitutional traditions of a country. Some legislatures have virtually unlimited powers to amend and change executive budget proposals, including changes that affect the Government’s overall fiscal stance. In other countries, parliamentary powers over the budget are constrained to only effecting expenditure re-allocations in the initial deficit target set by the executive. For example, in Croatia the 2003 Organic Budget Law and a subsequent version passed in 2008 requires that any amendment proposal needs to identify an offsetting measure to remain deficit neutral. Several different types of arrangements may be consistent with fiscal discipline, depending on the existence of other constraints faced by the executive and legislative arms of government. However, unlimited budgetary amendment powers require that constraints on fiscal expansion do exist in the budget review process to restrain elected representatives from overspending. Parliaments in ECA enjoy amendment powers of various types. Among those parliaments with unlimited amendment powers are those of Albania and Romania. Bulgaria, Poland, Russia, and Turkey are among those with limited amendment powers while the parliaments of Georgia and Azerbaijan do not enjoy formal amendment powers.

While there are common themes, such as policy based budgeting, performance orientation and medium term fiscal planning, fiscal reform challenges and priorities have varied across the region depending on the structure of the economy and other country characteristics. For example, the key fiscal policy and institutional challenge for oil and commodity exporters, like Russia, Kazakhstan and Azerbaijan was related to the prudent management of large revenue windfalls that have accrued over the past decade. For the new member states of the EU, reforms were driven by requirements of the accession process, including adoption of the SGP fiscal rules and fiduciary systems capable of managing and absorbing increasing transfers from the EU under the common agricultural policy and structural funds. In contrast, in some of the lower income countries the focus has remained on building the foundations for sustainable fiscal management with a focus on both reforms of revenue administrations to broaden tax bases and stabilize revenue generation and systems for prudent expenditure control. Below, we look at two institutional reforms aimed at supporting fiscal discipline, in more detail.

VI. Fiscal Rules

As mentioned in Part I, The basic rationale for fiscal rules is to create a mutually binding and enforceable set of rules and procedures to encourage fiscally responsible behavior across time and/or different budgetary entities. Pre-established fiscal rules are particularly useful in settings characterized by multiple constituencies with the ability to initiate spending and revenue policies. If properly designed, a rules based approach can help secure control over consolidated fiscal balances while allowing a prudent degree of flexibility to entity governments. Numerical fiscal rules can apply to all fiscal aggregates: expenditure, the deficit, the debt stock, and revenue (although there are few practical examples).

The proliferation of fiscal rules across the ECA region is a relatively new trend. About half of the countries in the region have adopted fiscal rules, mostly during the past ten years. The types of fiscal rules they have adopted vary greatly among ECA countries. The new EU member states all comply with the EU stability and growth pact, but only a few have embedded the supranational rules in their national fiscal-institutional framework. In other countries fiscal rules have been included in organic budget laws or specific debt management and fiscal responsibility laws while others have promulgated fiscal targets either as part of their Medium Term Expenditure Frameworks or as general political commitments. Deficit and debt rules are by far the most popular type of rules among ECA countries. All EU member states are committed to the deficit and debt rule of the Stability and Growth Pact. In addition, Hungary, adopted a deficit rule requiring the general government primary budget balance be in surplus. Armenia's debt management law passed in 2008 establishes an overall constraint on public debt at 60 percent of GDP and an additional limitation on the annual budget balance when debt is above 50 percent of GDP.

As countries are faced with pressures emanating from the recent crisis, they have often exceeded constraints established by their fiscal rules. In the recent crisis, fiscal rules, in particular those constraining deficits, have been criticized for reinforcing pro-cyclical fiscal policy. Many countries have chosen to pursue an expansionary fiscal policy stance in reaction to the economic downturn, sometimes at the cost of exceeding pre-established deficit limits.

VII. Medium-Term Expenditure Frameworks

Medium-Term Expenditure Frameworks (MTEFs) are tools which aim to introduce a more strategic approach to budget formulation and help focus on fiscal priorities with a medium- to long- term perspective. MTEFs typically comprise top down estimates of the expected aggregate resource envelope, bottom up forward estimates of expenditures required to continue existing policy commitments and a framework to reconcile the two. Fully elaborated MTEFs translate the government's macroeconomic and fiscal strategy into budgetary policy. MTEFs can help safeguard fiscal sustainability by projecting the fiscal impact of current budget decisions, including the recurrent cost implications of capital expenditures and the available resource envelope over the medium term and by enhancing transparency. For MTEFs to be effective tools for expenditure prioritization and budgetary decision-making they need to be procedurally and institutionally integrated with the annual budget formulation process. In practice, countries rarely adopt fully articulated MTEFs, but selectively and/or sequentially apply key elements.

Almost all ECA countries (26 of the 28 examined) are now experimenting with some form of medium-term budgeting**.** Most of the medium-term frameworks cover a three or four-year period. But the depth of medium-term planning and its impact on budgetary decisions vary across countries. Some countries prepare only forward estimates of fiscal aggregates (revenue, and broad expenditure categories) while others have developed full-fledged MTEFs with detailed bottom up expenditure estimates for existing programs as well as forward looking estimates.. The institutional coverage varies but many countries continue to cover only central government operations, though sub-national governments are included in the MTEFs of only a few countries, such as Armenia. In a majority of countries the institutional and procedural integration of MTEFs with the annual budget process is incomplete, undermining their real impact on expenditure prioritization. Only in some countries, like Croatia, Slovenia and the Slovak Republic are MTEFs formally adopted by Parliament; others adopt MTEFs as executive documents. A number of countries, including Armenia, Moldova and Russia have suspended the preparation of MTEFs in view of the recent volatility in the macro-economic environment. Economic volatility has thrown into uncertainty growth and revenue prospects, the costs associated with financing the deficit on world markets as well as expenditure needs arising from automatic stabilization.

VIII. Three Countries: How Fiscal Institutions Performed in Russia, Turkey, and Poland

In this section, we (a) examine the evolution of fiscal institutions during the 1990s and 2000s in Russia, Poland and Turkey in some detail; (b) discuss how these institutions and the degree of political fragmentation may have affected fiscal outcomes in the last decade; and (c) discuss how the latter in turn has affected institutional development.

The general developments in fiscal outcomes in ECA countries are reflected in the public sector outturns of Poland, Russia and Turkey during 2000-2010. Turkey's fiscal adjustment, as shown by its dramatic reduction in the deficit was particularly remarkable in the aftermath of the crisis in 2001 to 2006 (Figure 6). Poland's deficit also falls continuously during 2003-2007 and Russia's surpluses of the mid- 2000s are impressive. Turkey's performance is the most impressive in containing the share of government in GDP: in Turkey, outlays to GDP fell continuously from 30.8 to 23.7 in 2006 (rising slightly in 2007), This was also true of Russia (outlays fell from 38.3 percent to 31.6 percent in 2006 but rose 2.6 percentage points of GDP in 2007 as the government boosted spending just before the crisis (Figure 7). Expenditures to GDP fell less in Poland (44.7 to 42.2 percent in 2007) and the changes fluctuated in the period with some years seeing expenditures grow faster than GDP. The impact of the growth downturns in 2008 meant large deteriorations in the deficit for all countries as fiscal revenues fell (Figure 8). Also, all three countries protected expenditures during the growth collapse, Russia leading with a large stimulus package. In Turkey and Poland, debt to GDP rose while Russia used its oil reserves.

Figure 6: Fiscal Balance/GDP - Poland, Russia, Turkey (2000-2010)

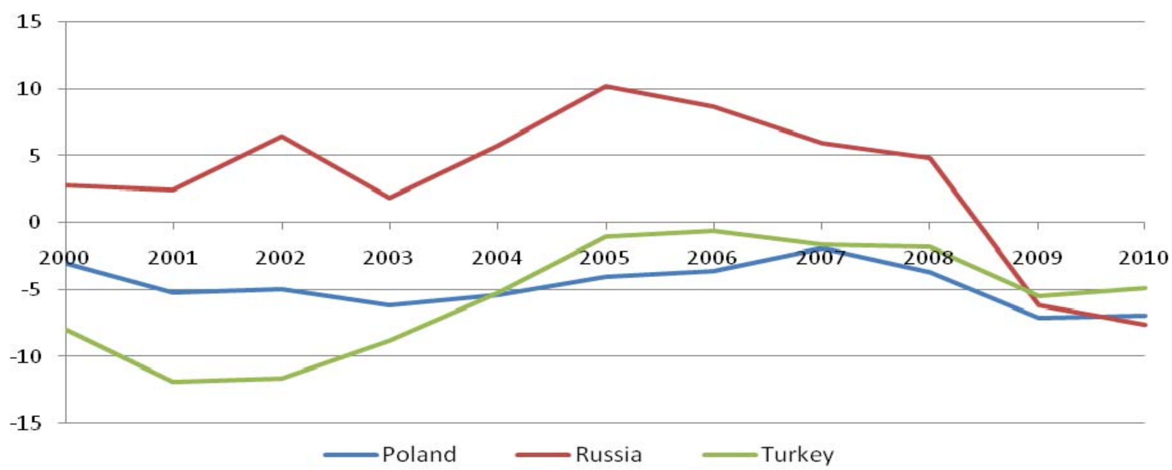
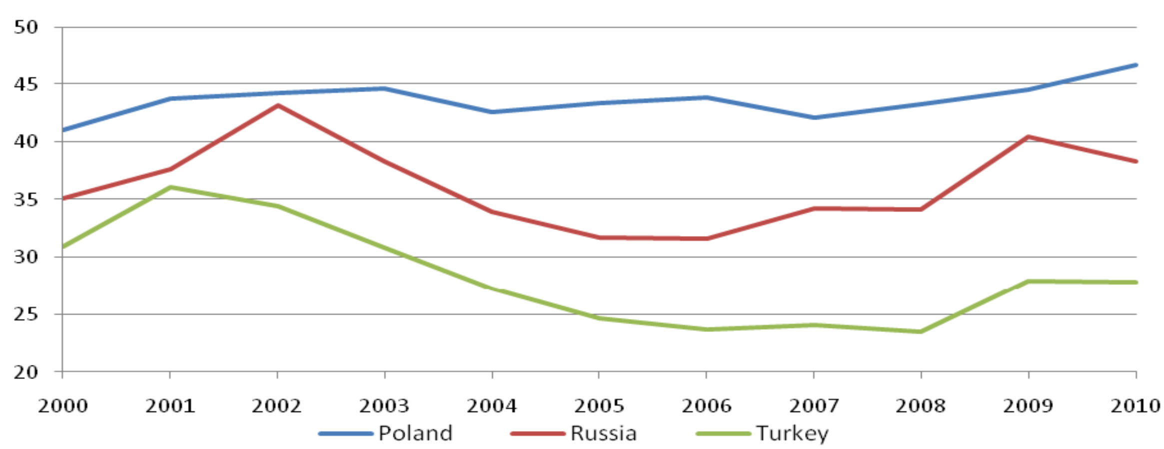
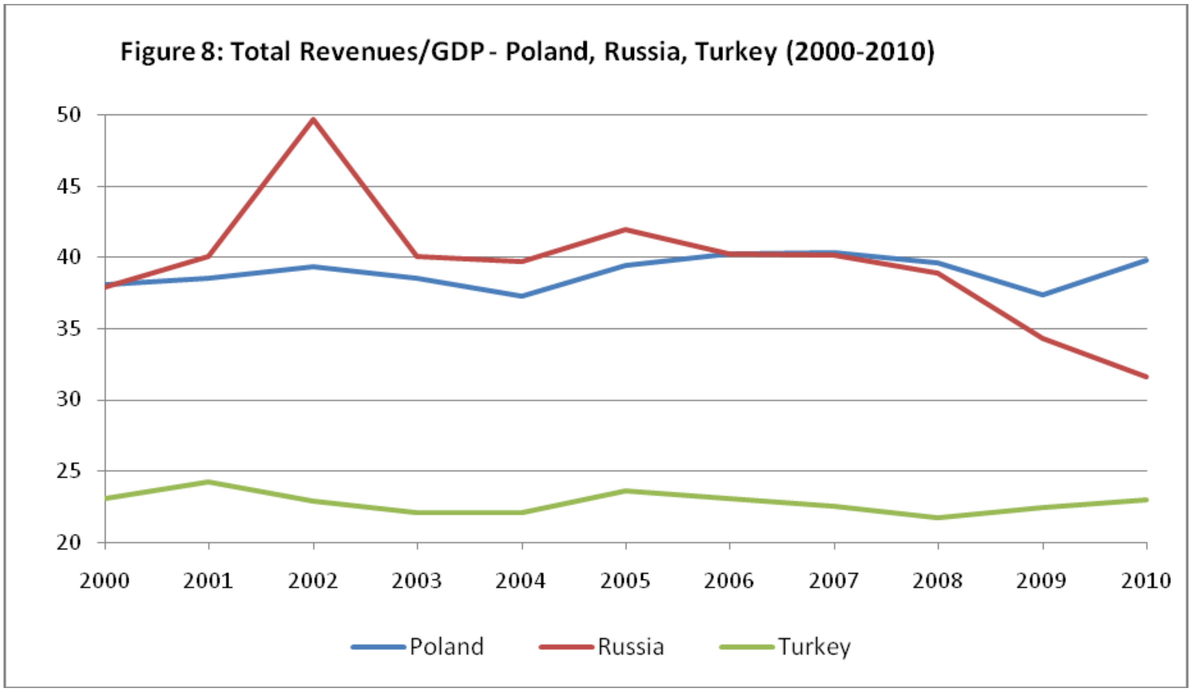


Figure 7: Total Outlays/GDP - Poland, Russia, Turkey (2000-2010)





The three countries had very different institutional conditions at the beginning of the 90s many of which were maintained till the early 2000s. Poland and Russia, the "transition economies" changed their institutions to more market-oriented ones but with different points of departure. In the early 1990s, Poland's institutional framework was closer to market principles because market supporting structures had been in place before WWII and the transition process began in Poland earlier than in Russia. Russia in contrast, experienced a more centralized form of socialism and for a longer period, so that when the transition began the gap with market supporting institutions was larger than that in Poland. Overall Russia's challenge compares with the challenge of other CIS countries that had a similar point of departure. Turkey was not a transition economy in the traditional sense but rather made a transition from a long-period of forced industrialization around an import substitution strategy which had run its course by 1980.

A. *Poland*

The Magdalenka Agreement of early 1989 in Poland (alternatively referred to as the Roundtable Negotiations), concluded negotiations between the incumbent communists and the opposition, thus setting the basis for new, democratic institutions. Building on strong popular support, the Government of Prime Minister Mazowiecki undertook wholesale reform combining macroeconomic stabilization with comprehensive institutional reform and the government put fiscal reform at the center of its agenda. Through a combination of expenditure cuts and revenue increases, it narrowed the fiscal gap; the headline deficit decreased from 8.5% of GDP in 1991 to 4.3% of GDP in 1998 and 2.3% of GDP in 1999. Other reforms, such as privatization and regulation to harden budget constraints focused on clarifying the boundaries of the state.

After a severe economic contraction in 1991, rapid economic growth and macroeconomic stabilization made Poland one of the leaders of the early transition period. In 1991, parliament approved the first comprehensive public finance law (Budget Law) that adjusted fiscal institutions to the new market economy regime. Later, the 1997 Constitution mandated restrictions on the level of the national debt, banned financing of the deficit by the Central Bank, empowered parliament to introduce changes to the draft of the State Budget and mandated parliament to pass a new comprehensive legal act on public finance. The constitutional rules on public debt stipulated maintaining (i) the outstanding central government public debt below 60 percent of GDP and the (ii) the ratio of debt service to revenues for local governments below 15 percent. The Public Finance Act that became effective January 1, 1999 mandated specific actions in the case that public debt moved close to 60 percent of GDP. In addition, it laid out the framework governing the coverage of the budget, the roles of the budgetary units (departments and agencies), the procedures at the central and the local level of government and the submission of the budget to the parliament, among related aspects. The fiscal rules gave the legislature powers to revise and alter revenue estimates and expenditure programs as long as it maintained the government-proposed nominal deficit levels. The President maintained the power to veto the budget proposed by the legislature. The legislation confirmed an independent audit agency, known as the Supreme Chamber. On availability of information, the Constitution and the Public Finance Act defined with precision the required scope and dates of publishing core fiscal information.

Political and institutional fragmentation still remained issues and their effects on the budget were aggravated by the lack of a single treasury account where budget units would maintain sub-accounts within a consolidated budget.[17] In addition, EU programs and projects were not included in budgetary estimates of expenditures or financing and thus were not part of the appropriation process of the legislature, although counterpart allocations, met from local sources, were included in the budget (albeit separately appropriated.) Upon Poland joining the EU in 2004, additional fiscal rules became mandatory and greater fiscal transparency was required. The 3 percent of GDP ceiling on the fiscal deficit under the Growth and Stability Pact complemented Poland's rules on public debt. Amendments to the Act on Public Finances in 2001 and 2003 to comply with the *acquis communitaire* meant an additional strengthening of the 1998 fiscal reform efforts. Yet, all these reforms did not succeed in reducing fragmentation. A review by Von Hagen (2006) stressed that the authority of the Ministry of Finance within the cabinet and in relationship to Parliament faced constraints. Namely, the full cabinet had the power to

[17] WB OER 2003. Note however, that the lack of a single treasury account probably itself reflected a lack of political consensus on its desirability.

override the Ministry of Finance and Parliament to make substantial modifications to the budget. Von Hagen pointed to how the fragmented political system at the time was an additional source of incoherence that affected the design of fiscal institutions. After reaching a peak of 6.7 percent growth of GDP in 1997, in the aftermath of the Russian crisis economic growth in Poland slowed in the early 2000s. At the same time, the public sector deficit jumped from 3.4 percent of GDP in 2000 to 5.9 percent of GDP in 2004, driven by increases in transfers and subsidies, with the public debt to GDP rising from 37.6 in 2001 to around 47.1 percent in 2005. Despite Poland's significant reforms, fiscal consolidation failed in the face of fragmented politics. Public expenditures remained high and social transfers (whose share of GDP continued to increase) much higher than other countries in the region with similar incomes per capita.

But, the booming external environment supported Poland's economic and fiscal recovery around the mid-2000s. However, the economic situation did not galvanize the authorities into action on expenditure rationalization. As growth eased the debt burden, fiscal rules and constraints were not binding- the debt/GDP ratio came down to 44.8% by 2007. Fiscal improvements allowing consolidation of EU funds into the budget and the incorporation of extra-budgetary funds were implemented. Most importantly, in late 2007, a new government with parliamentary majority came to power and moved forward reforms that began to address points of fiscal weakness—pensions, taxes and social security contributions. These reform initiatives were launched before the crisis and were grounded partly (i.e. reduction in social security contribution) in the buoyant public revenues at the time. Poland's fiscal improvements were substantially affected by the general economic reforms. Fiscal institutions did not contain expenditure growth.

When the global crisis struck in 2008, Poland undertook some fiscal expansion. Poland's economy suffered less than many others in the region, with the more moderate dependence on the external sector softening the impact of the external crisis. The government borrowed externally from international capital markets and official donors and undertook further expenditure rationalization, while providing support to the economy. The IMF estimates that the country provided significant fiscal stimulus during the crisis, with a discretionary fiscal relaxation estimated at 1.15 percent of GDP in 2008 and 2.5 percent of GDP in 2009, in part resulting from tax cuts that were approved prior to the crisis and not compensated by budget cuts as initially intended in 2009. The increase in the fiscal deficit from 2 percent of GDP in 2007 to 7 percent of GDP in 2009 reversed the trend in place since 2000. The excessive deficit procedure under the SGP was initiated in 2008 due to the deficit overrun. [18] As a consequence public debt escalated from 45 percent of GDP in 2007 to an estimated 51 percent in 2009.

Overall expenditure control remains relatively weak. The 2010 Bank Public Expenditure Review[19] (PER) stressed the need to better align budgetary allocations within a mid-term consistent framework, a point that the 2003 PER had stressed but where apparently progress had been limited. Some MTEF elements were introduced with the new Law on Public Finance of 2009 and the first adoption of the Medium-Term Financial Plan of the State in late July 2010. Despite the national and supra-national rules and reforms in tax administration, Poland could not contain its deficit or debt to GDP ratios. Fiscal rules could not substitute for political fragmentation and were not useful in a crisis.

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[18] In 2009, despite a preparation to reduce state expenditures by 10 percent, state related expenditures, excluding EU-related spending, increased by 20 percent in current prices during the first half of the year, but the July supplementary budget changed the 2009 to cut expenditures helping contain the general budget deficit to about 6 percent of GDP.

[19] Public Expenditure Reviews by the World Banks assess the fiscal policy and institutions, particularly as they relate to fiscal expenditures.

The fiscal situation in 2009 led the government to revise the Public Finance Act to strengthen commitment to (a) a level of public debt lower than 60 percent of GDP, (b) a medium term framework for the planning of public expenditure; (c) introduction of performance-based budgeting; (d) further consolidation of government (reducing fragmentation); (e) stronger control and internal audit, and (f) separation of EU funds from other items in the state budget. The revised Public Finance Act strengthens the previous safety thresholds and requires additional corrective actions if the debt exceeds 55 percent of GDP.

For Poland's expenditure-based adjustment to succeed, the country needs to address the political and economic fragmentation that has put upward pressure on expenditures and delayed fiscal adjustments. Recent legal initiatives, including the revision of the Public Finance Act and the reform of social security, could ease such pressures; the latter will reduce the fiscal risk that could arise from the growing elderly population. Going forward, Poland's fiscal consolidation strategy includes plans for two new fiscal rules: (a) to limit the growth in discretionary budgetary spending to 1 percent over inflation over the next few years; and (b) over the longer-run, introduce a fiscal rule through a new public financial stability law to prevent a pro-cyclical fiscal pattern in public finances. The institutional reforms that commenced in 1998 need to be strengthened to contain political fragmentation, recent legislation reduces institutional fragmentation but does not strengthen the powers of the fiscal authorities or constrain parliamentary powers to revise the budget. Lacking strong fiscal powers the authorities may find it difficult to enforce (top-down) fiscal envelopes for the whole public sector.

B. Russia

After the transition began in 1991, the building of fiscal institutions in Russia proceeded slowly. A highly fragmented fiscal system emerged; Federal Government expenditures were less than half of total public expenditures with the rest accounted for by the sub-national governments. The fragmented fiscal structure meant fiscal outcomes were hard to contain placing the country in a weak position as it faced the 1998 crisis. In the pre-1998 period weaknesses in tax policy, tax administration and budgetary management reinforced each other. The lack of adequate expenditure control and the inability to collect revenues meant the authorities used noncash mechanisms to settle budgetary commitments. They accumulated arrears. In fact, ad-hoc expenditure cuts and budgetary arrears became pervasive at all levels, including in extra-budgetary funds and sub-national governments. The Federal Government accounted for the bulk of the overall public deficit (expenditures were pushed up by rising transfers and interest payments); its fiscal space was shrinking as revenues were declining (from 15.6 percent of GDP in 1992 to 11.6 percent in 1997). In response, the Federal Government tried to control the deficit by cutting expenditure (from 26 percent of GDP to 18.4 percent) but did so in an ad-hoc manner. Russia's fragmented political system blocked efforts at fiscal reform; for instance the Duma rejected a fiscal reform package in July 1998 just before the financial crisis hit.

During the crisis, the economy contracted and the debt to GDP ratio reached over 90 in 1999. With a new government in place, the authorities undertook a dramatic shift in fiscal and macroeconomic policy, and by 2002 the general government was running a surplus which it maintained until the crisis of 2008-09. But, the financial crisis of 1998 was clearly a watershed event for Russia's fiscal institutions and fiscal performance and it led to a turnaround among politicians and technocrats. The cooperation between the executive and the Duma increased, beginning with the approval of a tough 1999 budget that included significant reductions in expenditure including at the regional and the local levels. Changes went beyond the approval of tight and demanding budgets. The government abandoned the practice of using tax offsets to pay its obligations and this helped foster revenue mobilization and reduced barter transactions in the economy. In addition, control over regional and local government finances increased, as did the share of taxes channeled through the federal budget. From 2000 to 2005, the authorities overhauled fiscal institutions in several core strategic areas beginning with the reform of the tax system, including the adoption of a flat income tax and reduction in the corporate income tax rate. Tax administration reforms efforts complemented tax policy initiatives. In 2002, a single Treasury Account brought all government expenditures together at the Central Bank. The revision of the budget code laid out sound principles for budget preparation, execution and reporting covered the sub national governments and established limits on their deficits and borrowing capacity.   In a significant step, the government undertook to manage its oil revenues better and introduced an Oil Stabilization Fund (created in 2003 and operational in 2004); later in 2008 this Fund would be split in two: (a) a Reserve Fund (aiming to insure against price volatility) and (b) a National Welfare Fund (for inter-generational equity.)

There were questions however about the sustainability of the adjustment because it initially held social payments and wages below inflation. However, as the finances of the public sector improved, aided by increases in oil revenues which by 2000 had already reached 7.5 percent of GDP- concurrently, expenditures rose and the non-oil fiscal deficit to non-oil GDP that had reached a surplus in 2000 became a growing deficit thereafter. This development however did not impair a rapid reduction of the overall public debt, a reduction that was aided by the rapid growth in oil export revenues, non-oil revenues to GDP, and negative real interest rates.

The reform of the fiscal relationship across the levels of government proceeded gradually, beginning with the passing in 2003 of a comprehensive decentralization reform that radically reshaped the powers of the local governments in Russia. This legislation was enacted in 2006 and full implementation commenced in January 2009. In addition, the 2004 Budget Code and the 2004 Federal Law on the Distribution and Assignments between Levels of Government tightened the assignment of spending mandates. Federal grants to regions came under common rules that limited them to equalization, matching and compensation for federal mandates. The use of formulae for equalization transfers as mandated by the Budget Code has replaced previous negotiations between the Federal Government and the regions. The legislation endeavored to clarify over-lapping responsibilities between the Federal government and the regions, to eliminate unfunded mandates and to reduce excessive expenditure obligations.

Despite buoyant public sector revenues, fiscal institutional reform continued and focused on second generation reforms that included the introduction of multi-year and performance budgeting (2007), that allowed line ministries to conclude multi-annual contracts and distinguish between the baseline budget and new budget initiatives. The need to respond to the crisis in late 2008, however, led to a suspension of the first multiyear budget adopted in 2007. Further revisions to the Budget code in 2007 tightened the fiscal rules and increased the constraints on extra-budgetary activities of government units and public enterprises, which was complemented with efforts to terminate quasi-fiscal spending by public corporations in which the Russia Federation holds a stake.

As a result of all these reform, Russia's fiscal institutions and fiscal performance improved vastly during the 2000-2008 period. These improvements meant that Russia entered the 2008-09 recession in a fiscally strong period, with a large government surplus, a low public debt and sizeable fiscal reserves. In the last quarter of 2008, when the effects of the global crisis were beginning to be felt in Russia, the government responded with an array of policies. Russia's total stimulus package of about 6.7% of GDP over 08-09 was large when compared to that of other countries. The across-the-board institutional overhaul that took place in the decade after 1998 to addressing the crisis in 2008 and 2009 allowed the government to respond boldly using the room to maneuver created by the substantial level of reserves and the low public debt. As a result, the non-oil federal deficit reached 13.5 percent of GDP in 2009, and is likely to remain at a similar level in 2010. At the same time, it is estimated that a long-term sustainable level for the deficit is around 4.3 percent of GDP. The gap between this number and the current deficit implies the magnitude of the adjustment faced by Russia. (Bogetic et al. 2010).

Recent spending increases in Russia (which began before the crisis) reflect permanent shifts (in pension and wages, for instance) in a situation where long-term sustainability calls for a significant reduction in the non-oil deficit. The Reserve Fund has been depleted substantially but less than had been feared at the beginning of the crisis. Thus Russia, like Poland, faces significant challenges ahead in further consolidation of its budget. The institutional apparatus, set in place before the crisis, with emphasis on embedding the budget within a mid-term framework can serve to help maneuver the needed adjustment, but it will have to be anchored on a broad political consensus to increase the likelihood of sustainability. The adoption of new rules on oil revenues may signal a greater commitment to fiscal constraint.

C. *Turkey*

The opening and liberalization of the Turkish economy began in 1980 as the country started abandoning strict import-substitution policies. For the next two decades (1980-1999) Turkey faced periodic crises which combined stop and go cycles of growth and a rising level of average inflation. But efforts at fiscal adjustment did not take hold. Fiscal and political fragmentation was at the heart of the macroeconomic difficulties. For instance, two episodes during the 1990s (1994-1995 and 1998) increased the overall primary surplus of the central government through substantive reductions in expenditures and tax increases, but could not contain the deficit in the rest of the public sector. With the adjustment burden falling on the central government and with a private sector with limited appetite to pay more taxes, the efforts failed. The relative autonomy of various segments of the public sector reduced the fiscal space available to the center and its ability to manage the overall fiscal situation, leading to periodic increases in the overall public sector deficit, inflation and the public sector debt. In addition, underlying these two failed fiscal adjustments during the 1990s were weak coalition governments that could not implement the changes needed to impose hard budget constraints on the rest of the public sector. By 1999, the public sector debt as a percentage of GDP had grown to 61 percent from 35 percent at the beginning of the decade. Meanwhile the ratio of taxes to GDP remained relatively stable, despite a decade of efforts at tax policy and tax administration reform.

In 1999, in the wake of the Russian crisis, an adjustment effort supported by an IMF program focused on curtailing the fiscal powers of the non-central public agencies and enterprises. But, in 2000, the high level of short-term debt refinancing obligations of the public sector induced a fiscal/financial crisis that compromised a weak banking sector. Political and fiscal fragmentation led to a high level of spending and correspondingly large deficits financed by captive public banks. The situation was aggravated by the crawling peg established in 1999 which led the banks to make exchange rate “bets” they lost when the peg failed. Turkey faced one of its most severe crises in 2001. The crisis galvanized the authorities into action. They ruled out debt restructuring and focused instead on ensuring the ability to roll over debt and strengthen longer term sustainability through the generation of high primary surpluses. A critical part of the adjustment was to generate a primary surplus in the rest of the public sector. The adjustment relied as well on indirect taxes (VAT, special consumption tax, petroleum, tobacco, alcohol and motor vehicles) with a lesser contribution of personal and corporate income taxes. Deep structural reforms accompanied the program with a primary focus on the banking sector. Costs of bank restructuring amounted to about 15 of GDP. Turkey obtained sizeable multilateral and bilateral financial support complemented the high primary fiscal surplus to service and manage the debt bulge and to assure the continued availability of international finance. It took longer to reduce the vulnerability of the high level of debt, which was also relatively short-term. In contrast to previous efforts the rest-of-of the-public sector primary balance went from deficit to surplus for the first time since 1980. GDP did contract by 5.7% percent in 2001, but rapid recovery followed in 2002 and GDP grew by 6.2% followed by 5.3% in 2003.

Although the adjustment was undertaken under a coalition government the 2002 election brought in a single party government with an overall majority that went on to conclude the stabilization process and soon thereafter launched an overhaul of its fiscal institutions that the Public Financial Management Control Law (PFMC Law), effective in 2006, consolidated. The PFMC Law reformed the entire cycle from planning and budgeting to legislative scrutiny of budget proposals, internal control and audit, external audit and ex-post legislative control. The PFMC Law advanced a more consolidated view of the General Government to include Central Government, Social Security Institutions, and Local Administrations. In addition, it assigned responsibilities to a small set of core agencies, reducing fragmentation in decision making: the Ministry of Finance (MOF), the State Planning Organization (SPO) and the (Undersecretariat of the) Treasury. The MOF prepares, executes and reports on the budget; SPO prepares the macro-framework, which us then sued by the Treasury to develop the investment budget and manage the public debt (and cash flow). The MOF sets tax policy but a specialized agency (Revenue Administration) collects.

During 2003-06, the nonfinancial public sector primary balance was in surplus as was the central government and the rest of the public sector. The period saw a rapid decline in the public sector debt relative to the economy. Turkey was helped by rapid growth. The general government gross debt to GDP ratio fell from 78.6% of GDP in 2001 to 39.5% of GDP in 2008. By the last quarter of 2008, the he global crisis had affected Turkey. The authorities undertook a fiscal expansion in response to the crisis. The public sector primary fiscal balance went from a surplus of 4.1 percent of GDP in 2007 to a surplus of 3.4 percent in 2008 to balance in 2009. The decline in the primary fiscal balance was due to discretionary measures which amounted to 1.2 percent of GDP with the remainder coming from automatic fiscal stabilizers. These came mostly as transfers to the health and social security systems. In addition the government introduced temporary tax cuts (VAT) to induce consumption of durables; a moderate package of employment support measures would be introduced as unemployment increased.

The ability of the government to respond was certainly aided by the fiscal space that had been gained and the low level of public debt. Yet as the crisis recedes, Turkey will need to ensure budgetary prudence and to further strengthen its fiscal institutions. To lock in gains and guide the future fiscal stance, the government has proposed adopting a fiscal rule. Draft fiscal legislation sets an annual deficit ceiling that adjusts to cyclical conditions while converging gradually to the medium-term deficit target. The draft legislation also proposes important improvements to Turkey’s public financial management procedures, including more transparent and comprehensive reporting of fiscal projections and outturns, tighter oversight of local government borrowing, and strengthened controls to deliver spending outturns more in line with the budget. Recent announcements indicate that the adoption of the rule may be delayed.

Conclusion

ECA countries, including the three countries studied in some detail, saw improvements in the quality of fiscal institutions and in fiscal outcomes during the period under study. The improvements in fiscal outcomes before the crisis were aided substantially by a favorable international environment but also by improved fiscal institutions that reduced institutional fragmentation and enhanced transparency through significant investment in supporting systems. Political consensus (or lack thereof) has been a major determining factor behind the types of institutional progress and fiscal consolidation that has taken place. Periods of political consolidation have favored institutional improvements. In addition, the impetus for institutional reforms has gained momentum after the recent crisis.

At the eve of the economic crisis, the three countries seemed better prepared in terms of their fiscal accounts, than in the earlier 1998 crisis period. By 2007, they had all reduced their public debt to GDP ratios and improved primary fiscal balances. But large increases in tax revenues and GDP allowed expenditures to accelerate though the deficit fell: fiscal controls did not extend as well as they could have to expenditures. Neither was there substantial improvement in problems areas or rationalization of expenditure patterns. Russia had accumulated substantial international reserves from oil exports by 2007 but it succumbed to upward pressures on expenditures. Russia's high reserves saw it through the crisis, but the time is ripe for a more critical look at public sector expenditures and further constraints on the use of the oil fund. Turkey's expenditure cuts were remarkable until the latter half of the 2000s but Turkey can reduce its risks further through a more complete consolidation of the public sector finances and a renewed commitment to expenditure rationalization. Among the three, Poland, which also raised expenditures, is the only one that had a rise in the public debt to GDP ratio before the crisis, and this happened despite the multiplicity of rules and constraints it adopted in the EU accession process. For a variety of reasons, Poland weathered the crisis better, but its fiscal accounts continue to be endangered by rising debt. A political will to tackle social expenditures is critical to Poland's ability to further contain its fiscal outcomes. It is difficult to assess the impact of the institutional reforms in the crisis itself. The empirical evidence indicates that improved institutional frameworks were no match for the unprecedented swings in the macroeconomics in the region, but countries were able to maneuver more efficiently and decisively than in previous episodes in the last two decades.

Over the longer term, the crisis is likely to have two impacts. First, longstanding reforms in social programs, which had lost momentum due to the easy financing of the 2000s, are now more likely to be re-enacted, and lead to more sustainable public finances in the future. Second, the momentum for more binding fiscal rules is gaining strength, this time accompanied by substantial improvements in the underlying institutional capacity to enforce them. The principal weakness looking forward, of course, remains the unpredictability of the political process.

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